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External debt crisis and development

Report of the Secretary-General**

Summary

The present report, submitted in compliance with General Assembly resolution 59/223, reviews recent developments in the external debt of developing countries. It analyses the implementation of the Heavily Indebted Poor Countries Initiative and the financing challenges for countries having reached the completion point. New approaches within the Paris Club, including the Evian approach, and debt repayments are also reported on. The recent experiences of debt restructurings with private creditors are also reviewed, and the principles of an orderly debt workout process are discussed in the light of these experiences.

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I. Introduction

1. The General Assembly, in its resolution 59/223, requested the Secretary-General to submit a report to the Assembly at its sixtieth session on the implementation of the resolution and to include in that report a comprehensive and substantive analysis of the external debt and debt-servicing problems of developing countries. The present report is written in compliance with that request by the General Assembly.

II. Recent developments in external debt

2. The global economy demonstrated strong growth in 2004, due in part to the performance of developing countries, which experienced the highest growth rates in over 30 years. The strong growth of developing countries as a group has been attributed to the rapid growth of exports of goods and services.[1] The increases in income, exports and reserves, together with a slower rise in total debt stocks, led to improvements in several traditional debt indicators for this group in 2004 (based on estimated debt statistics for that year). However, the general improvement masks exceptions, as individual countries are still facing large unsustainable debt burdens. Furthermore, the continuation of strong trade performance can be thwarted by adjustments to global imbalances or by rapid increases in oil prices.

3. The rapid growth of trade in developing countries outpaced that of developed countries, largely because of China and India.[2] Developing countries in all regions except South Asia experienced an increase of about 20 per cent or more in their exports of goods and services in 2004. Developing countries built up a current account surplus of 2 per cent of gross domestic product (GDP) in 2004 and increased their accumulation of reserves (in particular, sub-Saharan Africa, by 49.7 per cent, and East Asia and the Pacific, by 42 per cent).

4. Total debt stocks for developing countries (including countries of Eastern Europe and Central Asia) rose by $43 billion, or 1.7 per cent, in 2004, as compared with 9.3 per cent in 2003 (see annex, table 1). Developing countries in Latin America and the Caribbean and in the Middle East and North Africa experienced modest declines in their total debt stocks of 0.8 per cent and 2.1 per cent, respectively. Most notable was the decline by 5.6 per cent of total debt stocks for countries in sub-Saharan Africa in 2004, in part due to the Heavily Indebted Poor Countries (HIPC) Initiative, as compared with the 9.4 per cent rise in 2003. In East Asia debt stock increased by a modest rate of 2 per cent and in South Asia by 1 per cent. In contrast, countries in Europe and Central Asia experienced a 7.8 per cent increase in their total debt stock, as compared with a 20.7 per cent increase in 2003.

5. The growth of gross national income (GNI) in developing countries outpaced the growth in debt in 2004, improving the total debt-to-income ratio for all developing countries to an estimated 35.2 per cent, down from 38.6 per cent in 2003. Despite the higher growth in total debt stock in countries of Europe and Central Asia, strong growth in GNI (19 per cent) in 2004 contributed to an improvement in the region's total debt-to-income ratio from 49.4 per cent in 2003 to 44.6 per cent in 2004. The largest improvement was found in sub-Saharan Africa, which experienced a decline in the debt-to-income ratio from 58 per cent in 2003 to an estimated 49.3 per cent in 2004.

6. Total debt service for developing countries decreased by about $38 billion (10 per cent) from 2003 to 2004. One notable exception is the increase in total long-term debt servicing in sub-Saharan Africa by an estimated $3 billion (26.6 per cent) in 2004. The increase in exports of goods and services and the decline in debt service for developing countries as a group resulted in a significant decline in the debt service-to-exports ratio, from 17.2 per cent in 2003 to 12.5 per cent in 2004, marking the largest decline in this ratio in the last 20 years.

III. Progress under the Heavily Indebted Poor Countries Initiative

A. Status of implementation

7. In April 2005, three additional countries, Honduras, Sao Tome and Principe and Zambia, reached their completion points, thus bringing the number of countries to reach the completion point to 18,[3] out of the current 38 countries eligible for debt relief under the Initiative. Nine countries remain between the decision and completion points. The International Monetary Fund (IMF) reported that countries in this interim stage encountered difficulties in maintaining macroeconomic stability.[4]

8. The remaining 11 countries, which have not yet reached the decision point under the Initiative, retain the status of "countries still to be considered". About half of them are conflict-affected countries, and many of them have substantial external arrears. As of March 2005, Côte d'Ivoire, Myanmar, Somalia, Togo and Liberia had no Poverty Reduction Strategy Paper (PRSP) in place. Some progress has been made in a few countries, with Burundi and the Congo expected to reach the decision point in 2005 and the Central African Republic expected to fully resume its PRSP in 2005. The Lao People's Democratic Republic has a proven track record for macroeconomic performance and meets the eligibility criteria, but the authorities have not availed themselves of HIPC debt relief.[5]

9. For International Development Association (IDA)-only and Poverty Reduction and Growth Facility-eligible countries that have yet to benefit from the HIPC Initiative, IMF and the World Bank have extended the sunset clause of the Initiative, initially set for 2004, until the end of 2006.

B. Heavily Indebted Poor Countries and the Millennium Development Goals

10. There is an increasing recognition that the HIPCs, including those which have gone beyond the completion point, are falling short of their Millennium Development Goals and will not likely be able to reach them by 2015 without substantial additional development assistance. For example, available information[6] indicates that the HIPCs which reached their completion point between 2000 and 2002 — Bolivia, Burkina Faso, Mauritania, Mozambique, and the United Republic of Tanzania — have achieved modest progress towards the Millennium Development Goals, but fall considerably short of the targets set for 2015. For these countries, total health expenditure as a percentage of GDP has remained relatively flat, with modest changes of one or two per cent during the period 1998 to 2002. Life expectancy at birth for these countries has declined from 1990 levels, except in

the cases of Bolivia and Mauritania. Some progress has been made with respect to the Millennium Development Goals on the literacy rate among the adult population, which increased from 8 per cent in 1990 to 14 per cent in 2002;[7] however, the percentage remained below 50 per cent for Burkina Faso, Mauritania and Mozambique.[8] With the exception of Bolivia, all of the completion-point countries are far from achieving universal enrolment in primary education.

11. In this context, the Secretary-General has noted that the HIPC Initiative has unlocked resources which are critical for achieving the Millennium Development Goals, but that they still fall far short of what is needed.[9] Defining debt sustainability as the level of debt that allows a country to achieve the Millennium Development Goals without an increase in debt ratios, the Secretary-General called for 100 per cent debt cancellation for HIPCs and more debt reduction for other heavily indebted non-HIPC and middle-income countries.

C. The Group of Eight proposals for debt cancellation for Heavily Indebted Poor Countries

12. In response to the call for full debt cancellation in support of the efforts of HIPCs to reach the Millennium Development Goals, upon the recommendation made by Group of Eight (G-8) finance ministers, on 8 July 2005 the G-8 agreed to 100 per cent cancellation of outstanding obligations of HIPCs to IMF, the World Bank and the African Development Bank.[10] For this purpose, additional donor contributions will be allocated to IDA and the African Development Fund (ADF), based on agreed burden shares, to offset the forgone principal and interest repayments of the debt cancelled. Burden-sharing also implies that non-G-8 donors should contribute. The cost of fully covering IMF debt-stock relief, without undermining the Fund's financing capacity, should be met by the use of existing IMF resources. The G-8 communiqué has not specified the sources of IMF resources for debt relief.[11] In situations where other existing and projected debt relief obligations cannot be met from the use of existing IMF resources, donors commit to provide the extra resources necessary.

13. Donors are also committed to cover difficult-to-forecast costs in excess of existing resources to IMF, IDA and ADF over the next three years, for an amount of $350 million to $500 million or more. These costs might result, for example, from debt relief for countries which may enter the HIPC process or for protracted arrears.

14. The plan will initially apply to the 18 HIPC completion-point countries and will be extended to additional countries as they reach the completion point under the HIPC Initiative. Mention is not made of other low-income countries not included in the HIPC Initiative which might need full debt cancellation to reach their Millennium Development Goals. While the G-8 initiative for 100 per cent cancellation of the multilateral debt is welcome, there are many questions relating to its modalities. The relief will be implemented in two stages: beneficiary countries will see their IDA and ADF allocation reduced by an amount equal to debt relief (no additionality in allocations); donors then provide additional resources to replace forgone reflows to IDA and ADF, resources which will be allocated to all recipients on the basis of need and performance. It is not clear whether these resources are additional to overall future aid commitments by donors or are simply shifted from

other allocations within the same aid budget. Furthermore, the debt owed by HIPCs to other multilateral banks is not covered by the plan.

D. Beyond the Heavily Indebted Poor Countries Initiative: the development financing conundrum

15. Some of the HIPCs which reached their completion points during the period from 2000 to 2002 have seen their debt increase beyond the levels deemed sustainable under the Initiative. The experiences of three such countries are briefly considered here. Bolivia reached its completion point under the enhanced HIPC Initiative at the end of 2000, after reaching the completion point under the original HIPC Initiative in 1998. An estimated $2.06 billion in nominal debt-service relief has been committed to Bolivia.[12] However, Bolivia's external debt at the end of 2003 was higher than it was prior to receiving debt relief in 2001,[13] as the net present value of its debt-to-exports ratio rose by 117 per cent, reaching 176 per cent at the end of 2003, above the HIPC sustainable threshold of 150 per cent. The new non-concessional debt more than offset the debt relief received, although export earnings have increased since 2001.

16. Burkina Faso reached the completion point under the original and enhanced HIPC Initiatives in 2000 and 2002, respectively. The estimated nominal debt-service relief committed to Burkina Faso amounts to $930 million.[12] By the end of 2003, the net present value of Burkina Faso's debt-to-exports ratio had risen to 199 per cent, from 150 per cent at the end of 2001.

17. Uganda was one of the first countries to reach the completion point under the enhanced HIPC Initiative, in May 2000, after reaching the completion point under the original Initiative in April 1998. Uganda is estimated to receive $1.95 billion in nominal debt-service relief.[12] However, the net present value of its debt-to-exports ratio was estimated to reach 258 per cent by the end of 2003, a level significantly above the HIPC sustainable threshold.[14]

18. There is also a concern that the Initiative provides for only a modest relaxation of a Government's budget constraints, as under the main provisions of the Initiative a Government may simply swap one type of spending commitment for another of equal value,[15] although debt relief has contributed to an increase in social spending. In cases where countries had accumulated significant arrears before benefiting from the Initiative, the transfer of budgetary revenue to the special account used to finance earmarked social expenditures implies additional expenditure, as arrears have to be cleared. In the end, debt relief has a positive impact on a country's balance of payments, as the Government transfers fewer resources to foreign creditors, but does not ease the budgetary burden faced by the Government.

19. Likewise, the issue of swapping one financial obligation for another under the HIPC Initiative raises the question of additionality of aid flows, as debt relief is included in the donor accounting of official development assistance (ODA). Debt relief provided to countries with debt arrears merely amounts to an accounting exercise.[16] ODA in the form of non-cash assistance and debt relief[17] does not bring additional budget support or foreign exchange transfer. Such forms of aid are important but must be received in addition to other forms of financing that allow countries more flexibility to design and implement development programmes. There is also a need to secure more stable, predictable and flexible aid flows for the

poorest countries. In this respect, for HIPCs which have reached their completion point and exited from the Initiative, the central question is what form financial assistance should take.

20. Debt sustainability for the poorest countries is best secured if financial resources come in the form of grants and if donors consequently agree to substantially increase grant-based ODA. In this respect, the commitment announced by the G-8 in Gleneagles to double annual aid to Africa is very welcome. Likewise, other proposals on innovative forms of development financing to generate additional sources of finance are encouraging. However, in cases where loans are still needed to fully finance the development requirements, the grant element of these loans may be linked principally to debtors' export prospects, as external debt can be sustainable only if debtor countries can earn enough foreign exchange to service their debt. The new IMF debt-sustainability framework links the terms of new financing to debt-sustainability indicators which are determined, inter alia, by export and growth prospects and also by the quality of policy and governance as measured by a Country Policy and Institutional Assessment index.[18] The macroeconomic projections on the basis of which debt-sustainability indicators are determined may not be always accurate, and the methodology used to assess the quality of the policy and institutional environment and the impact of that environment on debt sustainability may be imperfect. For these reasons, it is necessary to balance this analysis with alternative views and qualitative judgements, as stressed by the General Assembly in its resolution 59/223.

IV. Paris Club debt reschedulings

A. Evian approach

21. In October 2003, Paris Club creditors agreed on the Evian approach to deal with the debt of non-HIPC low-income and middle-income countries, taking into account not only the financing gaps but also the medium-term debt sustainability of these countries. The objective is to tailor debt restructuring to the financial needs of the country concerned and to ensure debt sustainability and an exit from Paris Club debt reschedulings.

22. For countries which face a liquidity problem but are considered to have sustainable debt, the Paris Club would apply the existing standard terms to a flow rescheduling. For countries which have debt-sustainability problems and are committed to policies implemented in the framework of IMF programmes that will allow an exit from future Paris Club reschedulings, the Paris Club will apply a comprehensive debt treatment, including flow treatment, stock reprofiling or stock reduction. Debt reduction, either through stock-of-debt reduction or debt-service reduction based on a concessional rescheduling, will continue to be considered only in exceptional cases.

23. The principle of comparable treatment with other creditors is reinforced under the Evian approach.[19] The adjustment of the cut-off date is also a noteworthy feature of the Evian approach.

24. Under the Evian approach, the Debt Sustainability Analysis (DSA) undertaken by IMF for each debtor country plays a critical role in shaping the outcome of debt

restructuring. The sustainability of a country's external debt is determined by the projected flows of revenues and expenditures, including those for servicing debt, as well as changes in exchange rates. In addition to estimating financing gaps and identifying the sources of financing (including different scenarios of debt rescheduling), DSA includes an analysis of debt dynamics to determine the stability of debt-to-GDP or debt-to-government revenue ratios. Stress testing is applied to baseline scenarios in order to take into account vulnerability factors.

25. Of the six cases (the Dominican Republic, Gabon, Georgia, Kenya, Kyrgyzstan and Iraq) treated under the Evian approach (see annex, table 2), two are deemed unsustainable: Iraq and Kyrgyzstan. While Iraq is clearly a special case, the analysis underpinning the Paris Club decisions concerning the other cases is not clear.[20]

26. While the Evian approach is presented by the Paris Club as an improvement on the traditional terms applied to middle-income countries, it nevertheless raises a number of questions. First, the factors which allow a distinction to be made between liquidity and solvency problems are not clearly set. What determines a liquidity crisis? Is it because the projected financing gaps can be filled by a traditional flow rescheduling of the Paris Club? Or because of a temporary shortfall in exports, or a temporary lack of access to foreign lending, or a bunching of debt maturities? It is also well known that a liquidity crisis can become a solvency crisis if the relief on debt servicing is not sufficient to promote a strong recovery.

27. Secondly, the Evian approach is characterized by a case-by-case treatment, resulting in a lack of clarity concerning the criteria or methodology used to determine the outcome of Paris Club debt renegotiations. Finally, despite the highly technical character of DSA, it does not address many issues. For example, there is no clear determination of sustainability conditions (such as thresholds for debt ratios or any other criteria), nor clear determination of the links between development policies and sustainability (focus being put mainly on macroeconomic policies), nor of the links between sustainability and vulnerability factors (treated as deviations from baseline scenarios). Most important, the projections of exogenous factors such as export and GDP growth rates often remain too optimistic.

B. Other debt renegotiations

28. The Paris Club has also recently allowed debt buy-backs or prepayment operations.[21] In 2005, a number of debtor countries offered a prepayment at par of whole or part of outstanding Paris Club debt, taking advantage of lower interest rates to raise funds on capital markets for that purpose or using their extra cash funds. In March 2005, Poland offered a prepayment at par of €11.6 billion of Paris Club debt, by issuing bonds for that purpose; 11 creditors have accepted the offer so far and have been prepaid €4.4 billion. In May 2005 the Russian Federation offered to prepay at par $15 billion of its debt; an overwhelming majority of creditors have indicated their acceptance, and payments are expected to end in August 2005. In June 2005 Peru offered to prepay at par up to $2 billion in principal maturities of its non-ODA debt falling due between August 2005 and December 2009. The majority of Peru's creditors have indicated their acceptance, and payments are to be made in August 2005. On 29 June 2005, the Paris Club creditors announced their agreement to enter into negotiations with Nigeria on a comprehensive exit debt treatment,

which would include debt reduction up to Naples terms on eligible debts and a buy-back at a market-related discount on the remaining eligible debts.

29. Following the December 2004 tsunami affecting South and South-East Asian countries, Paris Club creditors agreed to a deferral of debt-service payments falling due in 2005 for the affected countries. At the end of this period, debtor countries may request a five-year rescheduling of the deferred amounts. Sri Lanka and Indonesia have benefited from the tsunami debt moratorium.

V. Sovereign debt restructurings with private creditors

A. Experiences of Argentina and other countries

30. Since the 1990s private finance has shifted from international syndicated bank lending to international bond issues. Bond lending involves diversified groups of bond holders, including domestic residents, and can be issued under different jurisdictions. Because of this diversification, concerns have been raised that in case of crisis it would be difficult to reach an orderly and collaborative debt-restructuring agreement and that aggressive creditor litigations and protracted negotiations would lead to a stalemate or produce an outcome which would not correspond to the financial needs of debtor countries.

31. While discussion on an adequate framework for debt restructuring is still ongoing, there have been eight sovereign debt restructurings with bond holders since 1999: Pakistan in 1999, Ukraine in 2000, Ecuador in 2000, the Russian Federation in 2000, the Republic of Moldova in 2002, Uruguay in 2003, Argentina in 2001 and 2005 and the Dominican Republic in 2005.[22] Pakistan and the Dominican Republic restructured their bonds, in compliance with Paris Club comparable treatment requirements. The main features of some of these restructurings are reviewed below (see annex, table 3).

32. Analysing these experiences from an economic angle highlights some common elements:

(a) The economic conditions preceding the restructurings were generally characterized by a prolonged period of economic recession, accompanied by high budget deficits;

(b) Despite IMF lending and several rounds of IMF programmes, the economic deterioration could not be redressed, and in most of the cases there were runs on bank deposits and an ensuing bank crisis. A bank crisis tended to increase the debt of Governments because of the need to compensate for bank losses or to recapitalize banks in order to restore stability in the domestic financial system;

(c) As the balance of payments deteriorated, especially after interruptions of capital inflows and sometimes massive flights of capital, the national currency was sharply devalued. This sharp devaluation increased further the cost of debt servicing and the debt-to-GDP ratio.

33. Because of economic recession, it was often not possible to reduce budget deficits, either by reducing government expenditures or by increasing taxes. Monetary policy was undermined by the banking crisis, and any reduction of interest rates to boost economic activities would encourage further flight of capital

and stop capital inflows. Export-led growth did not take place rapidly after devaluation, because of either the narrow base of exports or adverse conditions in global markets.

34. The combination of all these factors contributed to an acceleration of government debt accumulation and made debt service difficult or impossible. In such a situation, the only option available for the Government was to seek debt restructuring to alleviate the debt burden or to have short-term cash-flow relief.

35. In some countries — Argentina, Ecuador and the Russian Federation — the debt crisis led to a suspension of payments or defaults on debt service. In these cases, debt restructurings produced a "haircut" on exchanged bonds. The size of the haircut tended to be commensurate with the depth of the economic recession before restructuring.

36. After the restructurings, almost all debtor countries experienced an economic recovery and regained external viability (also due to real exchange-rate depreciation), although in a context of more favourable global economic conditions. But the cost that the debt crisis imposed on the domestic economy was very high, and not only through a prolonged period of recession. Domestic entities, whether individual investors, pension funds or banks, which held a percentage of restructured bonds in the range of 10 to 72 per cent, had to bear a high cost resulting from deposit losses or from the discount on exchanged bonds or reductions in their present value. The losses incurred by domestic investors can have a long-term effect on the pension system or the banking sector.

37. The most recent debt restructuring of Argentina illustrated well the conditions described above. The factors leading to the deep debt crisis culminating in the 2005 debt restructuring were characterized by the conjunction of policies (constraints on monetary, exchange-rate and public-borrowing policies imposed by the currency board) and external shocks (devaluation of the Brazilian currency in 1999, Asian and Russian financial crises in 1998). Fiscal policy was left as the only countercyclical policy option. Starting from 1999, the first year of recession, fiscal deficits rose substantially, alongside the public debt-to-GDP ratio. The crisis also revealed the structural weaknesses of the economy, reflected in the restricted policy options of the central Government and the narrow export base.

38. The Argentine Government undertook a first debt swap in June 2001: government bonds with a face value of $29.5 billion were voluntarily exchanged for longer-term instruments. In November 2001, the authorities again restructured the public debt, this time exchanging dollar-denominated bonds for domestic guaranteed loans. In December 2001, the Government declared default on its external debt. In January 2002, the Government announced the end of the currency convertibility regime.

39. In January 2005, the Argentine Government presented bond holders with a new debt-restructuring deal, involving 152 bonds denominated in six different currencies amounting to roughly $82 billion and subject to eight legal jurisdictions. Proposals for bond exchanges at par, quasi-par or discounted values were divided in two scenarios, depending on whether bond-holder participation was below or above 70 per cent. As the final rate of participation was about 76 per cent (implying that about $62 billion was tendered for exchanges), the second scenario was retained.[23] The haircut on discounted bonds was equivalent to 66.3 per cent, which was the

highest ever reached in recent times. GDP-link was also introduced to allow extra payments in case actual real GDP exceeded the base-case GDP as projected by the Argentine Government. The authorities will issue $35.2 billion in new securities, comprising $15 billion in par bonds, $11.9 billion in discount bonds and $8.3 billion in quasi-par bonds. The new bonds, other than those governed by Argentine law, will include Collective Action Clauses (CACs). The Argentine Government estimated that after restructuring, the ratio of debt in foreign currency to exports was reduced from 527 per cent (in December 2001) to 230 per cent, and the ratio of interest payments to fiscal revenue diminished from 22 per cent to 10 per cent.

B. Proposals on debt restructuring frameworks

40. The experiences with debt restructurings reviewed above differ in several aspects, most particularly in the use of legal instruments, CACs or exit consents,[24] to resolve collective-action problems and inhibit the incentives for dissident behaviour (CACs for the Republic of Moldova, Ukraine and Uruguay and exit consents for Ecuador and Uruguay) versus the absence or non-use of such instruments (Argentina, Pakistan and the Russian Federation).[25]

41. As seen above, the results of negotiations were diverse. Some countries achieved a real exit from a debt crisis, while others continued to face a lingering debt problem or are considering new debt renegotiations (as in the case of Ecuador). This raises the question of the adequate level of debt relief which would truly allow debtor countries to grow out of their debt problems.

42. It also appeared that since the Russian crisis there has not been a contagion effect in the forms of drying-up of credit or higher spreads for other emerging-market countries. Moreover, some debtor countries which have gone through debt restructurings soon resumed their access to capital markets.

43. What lessons can be drawn from these experiences which would contribute to the design of an orderly debt workout mechanism? Some analysts assert that the existing process involves costly delays in seeking debt restructuring, that the debtors are not effectively protected from litigation actions by dissident investors,[26] that the debtor's incapacity to service debt in the short term is not sanctioned by a standstill on debt servicing in order to stop lawsuits to enforce the payment of debts which would be detrimental to the debtor, as well as to the creditors as a group.[27] Other legal instruments, such as bilateral investment treaties, may provide an additional avenue for litigation cases to be introduced against debtors.[28]

44. There have been many proposals on debt restructuring mechanisms. The most noteworthy was the IMF sovereign debt restructuring mechanism,[29] which suggested some core features: majority rule in restructuring decisions, a legal stay against claims by creditors, protection of creditors' interests, seniority of new money and a dispute-resolution forum.

45. The use of CACs under different jurisdictions was also strongly encouraged. In 2003, Mexico successfully issued new bonds which included CACs without incurring an increase in spreads, thus paving the way for a more frequent inclusion of CACs in emerging market bond issues.

46. A voluntary code of conduct was also developed by the Institute of International Finance, which proposed the Principles for Stable Capital Flows and

Fair Debt Restructuring in Emerging Markets. In November 2004, the Group of Twenty finance ministers and central bank governors welcomed the draft Principles as a good basis for strengthening crisis prevention and enhancing the predictability of crisis management.[10] The draft Principles are based on four pillars:

(a) Transparency and timely flow of information, at the time of issue and in case of restructuring;

(b) Debtor-creditor dialogue to explore alternative market-based approaches for dealing with debt-service difficulties in order to avoid defaults;

(c) Good-faith actions, which postulate that issuers and bond holders agree on the usefulness of a common understanding on best practices for engagement in cases of default. The role of creditor committees is to be determined on a case-by-case basis;

(d) Fair treatment, which sets guidelines on a no-discrimination policy in the treatment of all affected creditors in a situation of default.

47. In addition, the draft Principles encourage IMF to implement fully its lending into arrears (LIA) policy. However, the Fund noted some differences between the draft Principles and its LIA policy.[31] For example the latter does not require early negotiations with a creditor committee in case of default (unless the case is complex). The former do not cover voluntary standstills on litigation, while the Fund LIA does. The draft Principles call for a resumption of partial debt service, to the extent feasible, as a sign of good faith to facilitate a restructuring, but the Fund LIA is silent on this matter.

VI. Policy conclusions

48. Against the backdrop of better growth and export prospects in developing countries in general, the recent trends revealed a smaller accumulation of debt and lower debt-service burden. However, some groups of countries continue to struggle for a durable solution to their serious debt problems.

49. Despite notable progress in the implementation of the HIPC Initiative, there is an increasing recognition that the HIPCs are falling short of their Millennium Development Goals and will need substantial additional development assistance, including full debt cancellation. In this respect, the G-8 has recently agreed to provide additional resources in order to cover the cost of full cancellation of the HIPC multilateral debt. The modalities of implementation of the G-8 initiative need to be further clarified, notably on the additionality of resources and on the possible inclusion of additional beneficiary countries.

50. For countries that have reached the completion point, the challenge is to achieve lasting debt sustainability and avoid falling into a new debt trap. Unfortunately, available information indicated that for many of these countries debt ratios have increased above levels deemed sustainable under the HIPC Initiative. In most cases, fiscal deficits and lower export earnings were responsible for a deterioration of debt ratios. It is to be noted that in many HIPCs the implementation of the Initiative has not contributed to a real alleviation of the budgetary burden, because debt relief results in a swap of fiscal expenditures in domestic currency.

51. Beyond the Millennium Development Goals, the long-term sustainability of debt depends on the growth and export prospects of debtor countries and, hence, on their success in overcoming structural development problems. This will require additional resources to finance investments, in concert with increased access to export markets. In order to avoid debt-servicing difficulties and to achieve the Millennium Development Goals by 2015 without an increase in debt ratios, exclusively grant-based finance for most HIPCs is called for. Donors are encouraged to fulfil their increased ODA commitments in this regard. However, in countries where additional loans are necessary there is a need to promote responsible lending and borrowing and to link the grant element of such loans to the capacity to pay. In this respect, the determination of the terms of development assistance cannot be based uniquely on a debt-sustainability analysis framework developed by international financial institutions: inputs from debtor countries should also be taken into account.

52. The question of debt-sustainability analysis is also key to the resolution of the debt crisis of other low- and middle-income countries. Thus, the Paris Club's Evian approach relies on IMF Debt Sustainability Analysis for determining the terms of debt reschedulings. As pointed out above, given the uncertainty surrounding that analysis, the treatment of debt reschedulings cannot rely on one single view. The quantitative approach of the IMF analysis should be balanced by other views, including qualitative and policy judgements.

53. There is therefore a need for further analysis of the debt-sustainability concept, taking on board the views of other experts,[32] and there is an obvious need for capacity-building on this issue in debtor countries. Long-term sustainability of debt depends mainly on the growth and export prospects of debtor countries. It follows that debt sustainability should be part of the overall development strategy of a country, addressing debt, trade and finance in a coherent framework. Strengthening debt-management capacity should be an integral part of this strategy.[33]

54. The recent experiences of debt restructurings with private creditors are very diverse. In some cases, there were considerable delays in undertaking debt restructurings, leading to costly defaults and worsened economic conditions. The risk of litigation has also increased, especially because of a lack of collective representation mechanisms, the presence of vulture investors or the legal implications of bilateral investment treaties. But these experiences have also shown that when debt restructurings give enough breathing space and release resource constraints on development, economic recovery resumes quickly and countries truly exit from debt problems. The lessons learned point to the need to reach an international understanding on debt restructuring modalities (including voluntary code and international arbitration or mediation mechanisms) which would bring together official and private creditors in a collaborative and constructive dialogue with a view to resolving debt problems in an expeditious and timely manner and to equitably protecting the interests of debtors and creditors. The modalities could draw on the principles laid out in national bankruptcy procedures.

Notes

[1] United Nations: *World Economic Situation and Prospects 2005*, New York, 2005, p. iii.

[2] Ibid., p.1.

[3] The 18 completion-point countries are Benin, Bolivia, Burkina Faso, Ethiopia, Ghana, Guyana, Honduras, Madagascar, Mali, Mauritania, Mozambique, Nicaragua, the Niger, Rwanda, Senegal, Uganda, the United Republic of Tanzania and Zambia.

[4] See IMF: *HIPC Status of Implementation Report*, August 2004.

[5] IMF: *Lao People's Democratic Republic, Country Report 05/9*, January 2005.

[6] World Bank, *World Development Indicators 2005* online.

[7] For Mauritania, Mozambique, Uganda and the United Republic of Tanzania.

[8] According to 2002 data for the last two and 1996 data for Burkina Faso.

[9] See A/59/2005.

[10] See G-8 Gleneagles communiqué: http://www.fco.gov.uk.

[11] There has been a proposal to use the IMF gold reserve to finance IMF debt relief, but this was not considered by the G-8.

[12] IMF: *Heavily Indebted Poor Countries (HIPC) Initiative — Statistical Update*, April 2005.

[13] IMF: *Bolivia: Ex Post Assessment of Longer-Term Program Engagement*, Staff Report, April 2005.

[14] IMF: *HIPC Status of Implementation*, August 2004, pp. 69-70.

[15] See Burnside C. and Farnizza D.: "Hiccups for HIPCs?", *National Bureau of Economics Research*, Working Paper 10903, November 2004.

[16] World Bank: *Global Monitoring Report 2005*, Washington D.C., 2005; p. 184, footnote 7.

[17] The World Bank report, op. cit., noted that during the period 2001-2003 the majority of the nominal increase in ODA (two thirds) came in the form of non-cash technical assistance ($4.8 billion) and debt relief ($5.9 billion).

[18] See IMF: *Debt Sustainability in Low-Income Countries: Further Considerations on an Operational Framework and Policy Implications*, 10 September 2004.

[19] For example, the Paris Club agreement for the Dominican Republic in April 2004 was made contingent on the implementation of the comparability of treatment.

[20] At first sight, given the high levels of debt ratios of Georgia, Kenya and Kyrgyzstan before Paris Club debt reschedulings, it is difficult to comprehend the factors which allow a distinction to be made between the sustainable cases (Georgia and Kenya) and the unsustainable case (Kyrgyzstan). In the case of Gabon, sustainability could be explained by good price prospects of petroleum exports, and in the case of the Dominican Republic the debt ratios are low.

[21] Debt buy-backs involve buying back the claims at the net present value of the remaining cash flows; the net present value is calculated by discounting cash flows at risk-free rate plus a market-referenced common country-risk spread. Prepayments involve paying off at par the outstanding stock of debt.

[22] In May 2005, the Dominican Republic concluded an exchange of bonds with its creditors resulting in an extension of the maturity by five years. Investors tendered 91.2 per cent of the $500 million in bonds due in 2006 and 95.7 per cent of the $600 million in bonds due in 2013. Bond holders are to receive $456 million in bonds due in 2011 (with the same coupon of 9.5 per cent) and $574 million in bonds due in 2018 (with the same coupon of 9.04 per cent).

[23] Bond holders were offered three options. The first option offered par bonds carrying a low interest rate, a long grace period of 26 years and a final maturity of 33 years (until 2038). The second option offered a quasi-par bond, carrying a discount of 30.6 per cent on principal, payable only in pesos, and carrying a low coupon also payable in pesos, a long grace period of 33 years and a final maturity of 41 years (until 2046). The third option offered discounted bonds, carrying a discount of 66.3 per cent on principal, a higher coupon (part of it being capitalized), a grace period of 21 years and a final maturity of 29 years (until 2034). The present value of new bonds should be roughly the same under the three options.

[24] Collective Action Clauses included in bond or loan contracts would prevent a minority of creditors from blocking negotiations with the debtor. The exit-consents technique is used in an exchange offer where bond holders agree before the exchange to amend the non-payment terms of the bonds from which they are exiting. The amendment agreed through the exit consent impairs the bonds left in the hands of holdouts and is intended to induce high participation in the exchange. See IMF: *Reviewing the process for sovereign debt restructuring within the existing legal framework*, Policy Development and Review, International Capital Markets, and Legal Departments, 1 August 2003.

[25] In the case of Argentina, the Government firmly decided that there would be no further exchange offer on bonds not tendered.

[26] The risk of litigation has increased with the emergence of vulture funds that would buy distressed sovereign debt on the secondary markets and then sue for full repayment once restructuring negotiations commenced. The most famous case was that of Elliot Associates, a vulture fund, against Peru in 1995, ending up with full payment to Elliot by the Government of Peru

[27] The United Nations Conference on Trade and Development (UNCTAD) *Trade and Development Report 1998* (United Nations publication, Sales No. E.98.II.D.6), pp. 89-93, contained an extensive discussion of the applicability of the principles derived from chapters 9 and 11 of the United States Bankruptcy Code to international insolvency procedures for sovereign debt.

[28] Bilateral investment treaties which include bonds in the definition of investment can lead to claims against debtors for expropriation in the context of debt restructuring. For example, the Global Committee of Argentine Bondholders has considered the initiation of international investment arbitration, following the Argentine Government's decision not to reopen the debt exchange for investors who have not tendered their bonds. See IMF: *Progress Report to the International Monetary and Financial Committee on Crisis Resolution*, April 2005, pp. 29-30.

[29] See Krueger A. O.: *Sovereign Debt Restructuring and Dispute Resolution*, speech by Anne Krueger, First Deputy Managing Director of the International Monetary Fund, 6 June 2002.

[30] Communiqué of G-20 finance ministers and central bank governors, Berlin, November 2004.

[31] IMF: *Progress report to the International Monetary and Financial Committee on Crisis resolution*, 12 April 2005.

[32] For example, various views on debt sustainability were expressed during the United Nations multi-stakeholder consultations on sovereign debt for sustained development in 2005, organized as a follow-up to the Monterrey Conference on Financing for Development; see: http://www.un.org/esa/ffd/09multi-stake-consul-flyer-debt.htm.

[33] UNCTAD is implementing a project on development strategy and debt sustainability, which also integrates aspects of debt management.

Annex

Table 1
External debt of developing countries and countries in transition
(Billions of United States dollars)

	All developing countries and countries in transition			*Sub-Saharan Africa*			*Middle East and North Africa*			*Latin America and the Caribbean*			*East Asia and the Pacific*			*South Asia*			*Europe and Central Asia*		
	2002	*2003*	*2004[a]*	*2002*	*2003*	*2004[a]*	*2002*	*2003*	*2004[a]*	*2002*	*2003*	*2004[a]*	*2002*	*2003*	*2004[a]*	*2002*	*2003*	*2004[a]*	*2002*	*2003*	*2004[a]*
Total debt stock	2 336.5	2 554.1	2 597.1	211.4	231.4	218.4	150.2	158.8	155.5	746.2	779.6	773.5	498.2	525.5	536.5	170.2	182.8	184.7	560.2	676.0	728.5
Long-term debt	1 919.8	2 045.2	2 040.8	175.4	193.1	182.6	129.5	136.7	133.5	629.0	648.6	637.4	387.7	387.9	380.4	160.5	173.0	175.9	437.8	505.9	530.9
Public and publicly guaranteed	1 375.4	1 450.1	1 459.1	163.0	177.4	164.6	123.0	130.0	126.0	403.2	420.7	441.8	266.1	267.4	262.0	144.6	155.2	156.4	275.6	299.3	308.4
Private non-guaranteed	544.4	595.1	581.7	12.5	15.6	18.0	6.5	6.7	7.6	225.8	227.9	195.6	121.6	120.5	118.5	15.9	17.8	19.4	162.2	206.6	222.5
Short-term debt	320.8	402.1	460.4	29.0	31.1	28.8	18.5	20.3	20.5	78.9	83.3	93.5	99.0	125.5	145.4	7.3	7.2	6.5	88.2	134.8	165.6
Arrears	100.1	130.0	143.3	37.9	44.2	35.3	15.3	15.6	16.3	16.9	33.0	54.6	15.3	23.3	23.1	0.4	0.0	0.0	14.3	14.0	14.0
Interest arrears	36.7	47.7	50.3	13.9	16.9	12.9	2.8	2.8	2.8	6.5	13.6	20.3	7.3	8.5	8.4	0.1	0.0	0.0	6.1	6.0	6.0
Principal arrears	63.5	82.3	93.0	24.0	27.3	22.4	12.5	12.8	13.5	10.4	19.3	34.3	8.0	14.8	14.7	0.3	0.0	0.0	8.2	8.1	8.1
Debt service paid	372.6	419.8	373.8	13.0	12.2	15.2	17.8	20.8	22.4	135.2	149.6	121.1	87.3	92.0	82.8	17.7	24.8	16.4	101.6	120.3	115.9
Gross national income	5 876.7	6 624.1	7 368.2	304.9	398.7	442.7	388.9	432.3	460.5	1 634.6	1 666.2	1 782.5	1 782.8	2 003.3	2 232.8	648.2	757.6	822.3	1 119.0	1 369.3	1 631.7
International reserves	974.3	1 277.6	1 585.3	37.8	41.4	52.0	74.2	97.7	110.1	164.8	200.9	214.3	426.5	566.0	758.9	85.3	122.3	143.2	185.7	249.2	306.1
Debt indicators (percentage)																					
Debt service/exports of goods and services	18.3	17.2	12.5	10.6	8.5	8.7	12.2	12.2	10.7	30.2	30.7	20.9	12.2	10.5	7.6	13.7	16.2	10.0	21.2	19.8	15.1
Total debt/exports of goods and services	114.7	104.7	87.0	173.4	160.2	124.5	102.7	93.2	74.1	166.9	159.9	133.5	69.7	60.0	49.2	131.6	119.3	112.7	117.1	111.2	95.1
Debt service/GNI	6.3	6.3	5.1	4.3	3.1	3.4	4.6	4.8	4.9	8.3	9.0	6.8	4.9	4.6	3.7	2.7	3.3	2.0	9.1	8.8	7.1
Total debt/GNI	39.8	38.6	35.2	69.4	58.0	49.3	38.6	36.7	33.8	45.7	46.8	43.4	28.0	26.2	24.0	26.3	24.1	22.5	50.1	49.4	44.6
Short-term/reserves	32.9	31.5	29.0	76.6	75.0	55.4	24.9	20.8	18.6	47.9	41.5	43.6	23.2	22.2	19.2	8.5	5.9	4.5	47.5	54.1	54.1

Source: World Bank, Global Development Finance 2005, online database.
[a] Estimated.

Table 2
Paris Club debt reschedulings under the Evian approach

Kenya	*Dominican Republic*	*Gabon*	*Georgia*	*Iraq*	*Kyrgyzstan*
15 January 2004	16 April 2004	11 June 2004	21 July 2004	21 November 2004	11 March 2005
GDP per capita in 2003 $441	GDP per capita in 2003 $2 408	GDP per capita in 2003 $4 155	GDP per capita in 2003 $770	GDP per capita in 2003 $594	GDP per capita in 2003 $372
Paris Club debt **28.4%** of total debt	Paris Club debt **24.8%** of total debt	Paris Club debt **77.6%** of total debt	Paris Club debt **27%** of total debt	Paris Club debt **30.9%** of total debt	Paris Club debt **28.9%** of total debt
Sustainable case	**Sustainable** case	**Sustainable** case with goodwill clause	**Sustainable** case with goodwill clause	**Unsustainable** case	**Unsustainable** case
Terms: Houston	**Terms:** Classic	**Terms:** Classic	**Terms:** Houston	**Terms:** Ad hoc	**Terms:** Ad hoc
- Flow rescheduling	- Flow rescheduling	- Flow rescheduling	-Flow rescheduling	- Comprehensive treatment: 80% cancellation of the relevant principal (including arrears) in three phases: 1) immediate cancellation of 30% of debt stock; 2) reduction of 30% as soon as an IMF programme is approved; 3) reduction of 20% upon completion of the IMF programme	- Comprehensive treatment: 50% cancellation of the relevant principal (including arrears)
- Repayment of non-ODA credits over 14 years with 5 years grace; repayment of ODA credits over 19 years with 10 years grace	- Repayment over 12 years, 5 years of grace	- Repayment over 14 years with 3 years of grace	- Repayment of non-ODA credits over 19 years with 5 years grace; repayment of ODA credits over 19 years with 10 years grace	- After cancellation, repayment of non-ODA credits over 23 years with 6 years grace	- Repayment of remaining 50% of non-ODA over 23 years with 7 years grace; repayment of 100% ODA over 40 years with 13 years grace
- Consolidation period: 36 months (1 January 2004-31 December 2006)	- Consolidation period: 12 months (1 January 2004-31 December 2004)	- Consolidation period: 14 months (1 May 2004-30 June 2005)	- Consolidation period: 31 months (1 June 2004-31 December 2006)		- Capitalization of moratorium interest

Table 3
Recent sovereign debt restructurings with private creditors: main features

	Argentina 2005	*Uruguay 2003*	*Ecuador 2000*	*Ukraine 2000*	*Russian Federation 2000*	*Pakistan 1999*
Date of deal	January 2005	April/May 2003	July/August 2000	April 2000	July/August 2000	November/December 1999
Amount (US$ billions)	81.8	5	6.8	3.3	31.8	0.6
Participation rate (% of eligible)	76	93	97	95	98	95
Haircut (%)	66.3	0[a]	41	0	37.5	0
Lowered coupons	Yes	No	No	Yes	Yes	Yes (in part)
Extended maturities	Yes	Yes	Yes	Yes	Yes	Yes
GDP indexation	Yes					
Debt held by domestic residents (%)	41[b]		10	14	72	33
Conditions before restructuring						
Default	31 December 2001		September 1999[c]		December 1998/ June 1999	
IMF programmes	4 February 1998	29 March 1999	11 May 1994	25 August 1997	11 April 1995	20 October 1997[d]
	10 March 2000	31 May 2000	19 April 2000	4 September 1998	26 March 1996	
	12 January 2001	25 June 2002			20 July 1998	
	24 January 2003	1 April 2002			28 July 1999	
	20 September 2003					
Paris Club agreement					28 July 1999	30 January 1999
Banking crisis	Yes	Yes	Yes		Yes	
	March 2001-2002 (18 months) run on bank deposits	Bank run in July 2002	Began in early 1998, evolved into bank run in March 1999		August 1998	Freeze of large foreign currency deposits in mid-1998

	Argentina 2005	*Uruguay 2003*	*Ecuador 2000*	*Ukraine 2000*	*Russian Federation 2000*	*Pakistan 1999*
Duration of recession	1998-2002 significant contraction of real GDP (by cumulative 20%); recession in 1995 from Mexico crisis	1998 -2002 entered into a prolonged recession	1999 output contracted sharply from 2.1% to -6.2% from 1998 to 1999; then returned to 2.8% in 2000	Prolonged recession (8 years) during transition to market economies, by end of 1999 output fell to 40% of 1990 level	Experienced a strong contraction of output during the transition period with negative GDP growth 1990-1996 and 1998	Positive annual growth rates which slowed sharply in 1993 to 1.7% from 7.7% and in 1997 to 1% from 4.8%
Devaluation	Yes Collapse of the convertibility regime in 2002 (in the first six months of 2002, peso lost 74.2% of its value against the US$)	Yes Sharp devaluation (85%) after the decision to float in June 2002	Yes Strong devaluation (200%) in 1999 following decision to float in February 1999; January 2000 dollarization	Yes Significant devaluation via changes in exchange rate band in 1998; move to float March 1999	Yes August 1998: large devaluation followed by decision to float in September 1998	Yes Modest devaluation in 1997 (8.7%)
Current account deficit	Current account deficits fluctuated between 2.4% to 4.8% of GDP for the period 1992 to 2000; the current account shifted to a surplus of 8.9% in 2002	1993 to 2001 sustained a modest current account deficit ranging from 1.1% to 2.8% of GDP; that rose to a 8.9% current account surplus in 2002	Increase in the current account deficit from 1.3% to 9% of GDP from 1997 to 1998; that reversed to a 5.5% current account surplus in 1999	Current account deficit rose slowly from 2.2% to 3% of GDP from 1994 to 1998; which shifted to a current account surplus of 5.3% of GDP in 1999	1999 and 2000 sharp increase in the current account surplus from 0.07% of GDP in 1998 to 12.5% and 18% in 1999 and 2000, respectively	Current account deficit ranging from 2.7% of GDP to 7% of GDP for the period 1991-1998; current account surplus of 2.6% in 2001
Fiscal deficit	Deterioration in budget deficit since 1999, interest expenditure exceeding 20% of revenue in 2001	Fiscal deficit resulting from the recession and election spending; despite cautious fiscal policy fiscal deficit varied around 4% of GDP from 1999 to 2002	Problems with expenditure discipline and revenue generation contributed to fiscal deficit of 4.6% of GDP in 1999	Fiscal deficit ranged from 8.7% to 3.2% of GDP during the period from 1994 to 1997, contrasted with 24% of GDP in 1992	Large fiscal deficit was main policy challenge, due to weak revenue and expenditure control; fiscal deficit was 7.5% of GDP in 1997, one of the highest among transition economies	Large fiscal deficit due to weak revenue performance and expenditure slippages; from 1995 to 1998 the fiscal deficit ranged from 6.8% to 7.8% of GDP

Source: Various IMF reports, World Bank development indicators and other financial sources.

[a] An option was included to convert US$ 30-year bond into a US$ 12-year bond with debt reduction.

[b] Total public debt denominated in pesos and foreign currency.

[c] Defaulted on restructured loans, December 1998; defaulted on interest arrears notes, June 1999.

[d] In response to comparable treatment required by Paris Club.